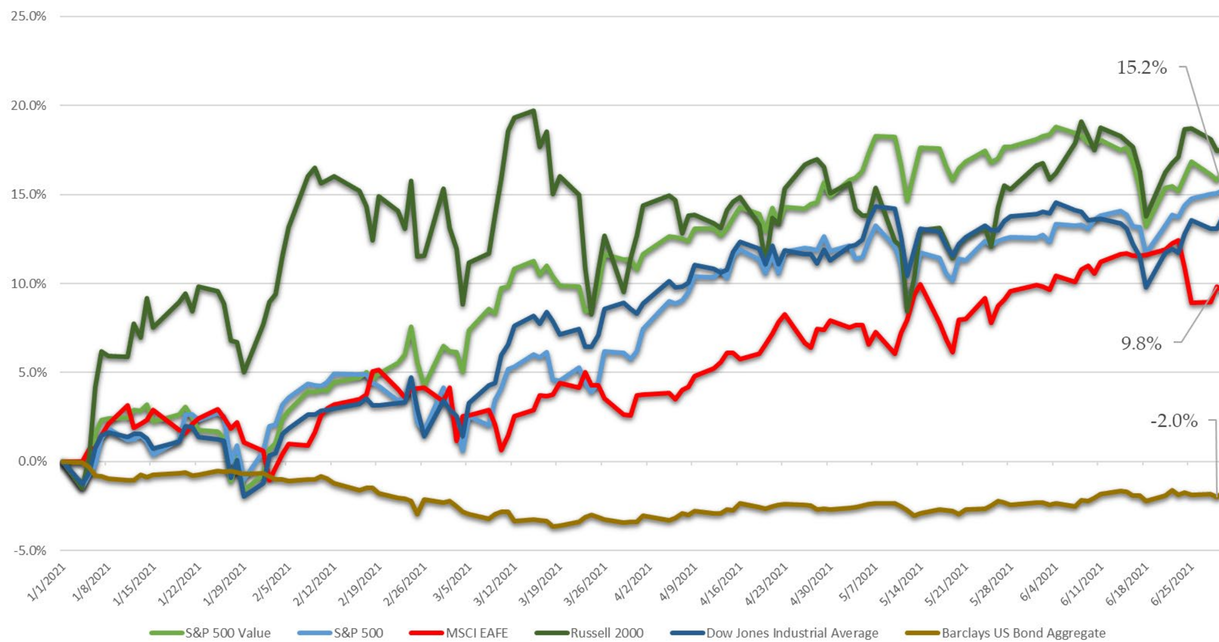
Dear Turtle Creek Client,

Global markets continued their post-COVID advance through the second quarter but did so amidst an increasingly sober outlook for economic growth, corporate profits, and the duration of the current highly stimulative Central Bank policies. The trends that dominated our first quarter analysis - accelerating inflation, surging commodity prices and interest rates, low quality cyclical leadership in stock markets – either ebbed or reversed during the quarter. Markets now appear to be signaling a more transitory nature to the recent economic surge and reducing expectations for the both the peak growth and length of this mini-business cycle fueled by historic but ultimately temporary government support.



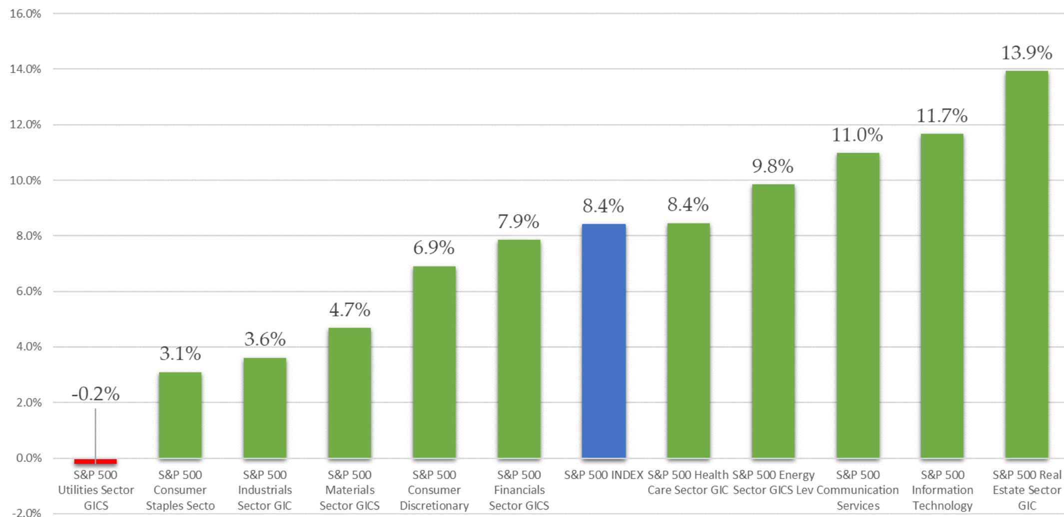
Source: Bloomberg

<u>Second Quarter Stock Market Performance</u>

The U.S. stock market built on first-quarter gains, advancing an impressive 8% and pushing the return on the S&P 500 Index to approximately 15% for the year. The “reflation trade” market leaders of the first quarter shifted to laggards as Industrial, Financial, and Materials companies trailed overall market performance. The relatively higher-quality Health Care, Communications, and Technology businesses carried the market higher.

Energy and Real Estate companies did buck this trend. Energy prices continued to climb as economic re-opening bolstered demand and global energy supply remained relatively constrained. The ongoing return of workers to the office and resumption of post-COVID daily life continues to benefit Real Estate firms.

The Consumer Staple and Utilities sectors continue to trail the overall market to a significant degree. Utility stocks posted a loss for the quarter while Consumer Staple companies advanced only slightly. Consumer Staples companies in particular are struggling against both rising input costs and the short-term rollover in the COVID-related binge buying of groceries, fast food, and household items.



Source: Bloomberg

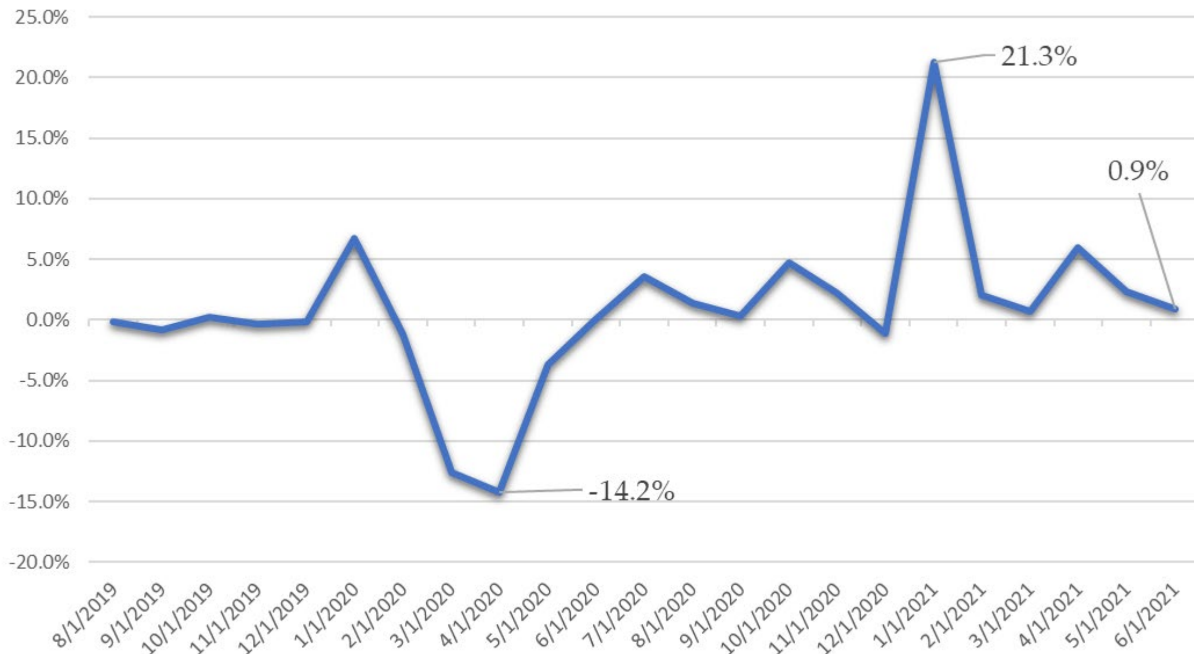
<u>Shifting Market Leadership Reflects A Moderating Expansion</u>

The U.S. stock market's shift away from economically-sensitive industries reflects the slowing and potential peak in the post-COVID economic recovery. While media outlets tend focus on the absolute, backwards-looking nature of data items like GDP or corporate earnings, the degree of change in these datapoints have more predictive value are more closely correlated with market behavior.

Macro-economic indicators ranging from jobless claims to retail sales posted healthy results throughout the quarter but in most cases only met or did not live up to optimistic forecasts. The Citigroup Economic Surprise Index, which measures the degree to which economic figures exceed or trail forecasts, sank noticeably through the last few months of the quarter.

Source: Bloomberg

Corporate earnings forecasts also failed to impress after several months of consistently improving profit outlooks. Consensus earnings estimates for S&P 500 companies barely budged throughout the latest earnings season, a noticeable shift from the first quarter which saw corporate executives raising their profit outlooks by more than 20%.



Source: Bloomberg

Fixed Income and Cash Markets

Bond yields also reversed course during the quarter with the benchmark 10 Year Treasury Bond yield declining 20 basis points and finishing at 1.5%. Moderation in economic data certainly influenced this reversal in yields but a shift in Central Bank communications also played an imporant role.

The Federal Reserve Bank has been largely dismissive of growing inflationary trends until recently when it changed its tune noticeably. Several Fed governors publically speculated during the quarter on the need for more aggressive tapering of current stimulus policies. The Federal Reserve's "Dot Plot", or its official forecast for the Fed Funds rates over the near-term, also surprised the bond market in June. Several Fed officials unexpectedly raised their forecast for the path of the Fed Funds rate, calling for rate hikes sooner rather than later.

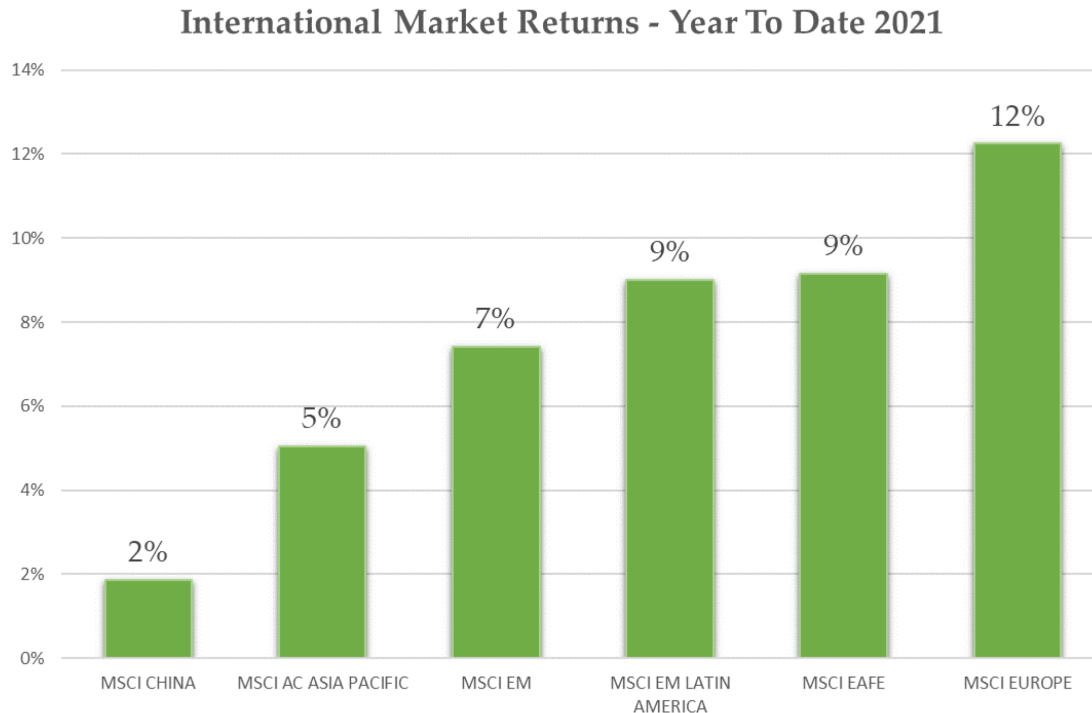
While it seem paradoxical that a Federal Reserve call for rate hikes should translate to lower bond yields, this more hawkish outlook alleviated much of the bond market's concern over the downside risks to the Federal Reserve's current highly stimulative stance. With the Fed both acknowledging the potential for economic overheating and laying the early groundwork for the relaxation of its curents policies, bond traders reduced their bets regarding the need for more aggressive rate hikes in the future to reign in inflation and unsustainable economic expansion.

The Fed is only discussing rate hikes at the moment, however, and money market yields remain near zero. With inflation now increasing at an annual rate of over 3% as measued by the CPI Index, the real (after inflation) yield on your cash holdings contines to be negative.

Source: Bloomberg

International Stock Markets – Earlier in the Cycle

Global stock markets have so far lagged the strong performance of U.S. equities as many international economies are earlier in their vaccination cycles and continue to struggle with economic lockdowns and less robust fiscal and monetary offsets to COVID headwinds. Chinese stocks have posted only marginally positive results for the year and have dragged down emerging markets performance in aggregate. Developed international markets have fared better, with European companies posting a 12% gain through the second quarter.



Source: Bloomberg

Investment Strategy

Even with this increasingly muddled economic backdrop, we believe our ongoing strategy favoring risk assets such as equities remains the appropriate framework. While sagging bond yields and fading cyclical stock performance are historically signs of a maturing business cycle, they have not reliably foreshadowed trouble for overall stock market returns in the past. They are also contradicted by other, more positive datapoints in both the stock and bond markets that imply sustained economic growth.

Credit spreads on corporate debt remain the smallest on record, a sign of strong confidence in future corporate profits. The Treasury bond yield curve also remains solidly upward sloping, traditionally a signal for sustained economic expansion. While corporate profit forecasts are no longer jumping to new highs, they still predict strong growth in earnings over the foreseeable future.

The risks that we have highlighted related to the safe asset allocation of your investment portfolio remain relevant. Even with bond yield sagging, the yield curve foreshadows increasing rates over the near-term and we continue to favor a short duration, high credit quality stance for your fixed income holdings.

The most relevant current opportunity is a tactical appraisal of your equity holdings. Considering that U.S. equities have rallied so strongly into a moderating economic backdrop and once again trade at premium valuation multiples, international investments represent an increasingly attractive alternative. They remain cheaper on a valuation basis and should benefit from an eventual acceleration in earnings as global economies catch up to the United States in fully opening their economies.

As always, we look forward to discussing these thoughts or any other questions soon

Sincerely,

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA

Turtle Creek Management, LLC | 3838 Oak Lawn Ave | Suite 1650 | Dallas, Texas 75204 | 214-468-0100 | 214-468-0106 fax |
turtlecreekdallas.com